STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NEW ENGLAND GAS COMPANY'S :
DISTRIBUTION ADJUSTMENT CLAUSE : DOCKET NO. 3548

REPORT AND ORDER

I. NEGAS' AUGUST 1, 2003 FILING

On August 1, 2003, the New England Gas Company ("NEGas"), a division of Southern Union, filed updated factors to the Distribution Adjustment Clause ("DAC") for effect November 1, 2003. NEGas' proposed DAC would decrease the bill for the average residential heating customer of NEGas by $13 per year.

In support of its filing, NEGas submitted pre-filed testimony by Peter Czekanski, Director of Pricing for NEGas. Mr. Czekanski explained that the DAC includes an annual system pressure factor related to liquefied natural gas ("LNG"), a Demand Side Management ("DSM") factor, a Low Income Assistance Program ("LIAP") factor, an Environmental Response Cost ("ERC") factor, an On-System Margin Credit factor, a Weather Normalization factor, an Earning Sharing factor, and a Reconciliation factor for the previous year. In addition, through June 30, 2004, there is a Consolidation Mitigation Adjustment factor and an Energize Rhode Island ("ERI II") adjustment factor. The Consolidation Mitigation Adjustment factor is designed to phase in the implementation of a consolidated statewide tariff. The ERI II adjustment is designed to credit former Providence Gas customers for the final calculation of net benefits achieved under the ERI II program. NEGas proposed no changes to these last two factors.[1]

As for the system pressure factor, NEGas proposed an increase in the factor to $0.0047 per therm. The factor is based on the commodity related portion of LNG costs

[1] NEGas Ex 1: (Czekanski's direct testimony), pp. 2-4.

projected from November 2003 through October 2004. In regards to DSM, Mr. Czekanski explained that the DSM program was established in Docket No. 2025 to promote the development of energy-efficient natural gas technologies that increase utilization of natural gas during periods of low demand. He noted that increased off-peak usage reduces the unit cost of gas for all customers by generating distribution revenues to support fixed costs associated with resources needed during peak periods. NEGas proposed no change to the existing level of funding, which is $300,000 annually. For LIAP, Mr. Czekanski stated that this factor can provide additional funding to LIHEAP and to a low income weatherization program. He noted that annual funding in distribution rates for LIHEAP and weatherization are $1,585,000 and $200,000 respectively.

In relation to the ERC factor, NEGas proposed a decrease in the factor to ($0.0019) per therm. This factor reflects a 10 year amortization of environmental response costs. The net environmental costs for fiscal year 2003 are negative because NEGas' net proceeds from insurance settlements were $9.5 million. In the area of non-firm margins, NEGas proposed an increase in the credit to ($0.0012) per therm. Mr. Czekanski calculated that NEGas recorded $2,165,151 of non-firm margins or $565,151 more than the $1.6 million threshold, which results in $423,863 to be credited to customers and $141,288 to be retained by shareholders. As to weather normalization, NEGas proposed a decrease in the factor to ($0.0123) per therm. Mr. Czekanski noted that during the winter period of November 2002 through April 2003, the weather was colder than normal and there were 478 degree days in excess of the threshold. As a result, $4,302,000 was to be credited to customers.[2]

Mr. Czekanski explained that the earning sharing calculation had not been completed because NEGas' financial data for the fiscal year ending June 30, 2003 had not been completed but NEGas will supplement this filing providing the calculation no later than September 1, 2003. As for the reconciliation factor for fiscal year 2003, NEGas proposed a factor of $0.0011 per therm. The total undercollection was $399,433, which was due to LNG commodity costs being higher than projected.[3]

II. NEGAS' SEPTEMBER 2, 2003 FILING

On September 2, 2003, NEGas submitted the direct testimony of Robert Riccitelli, Manager of Financial Reporting and Budgeting for NEGas, and the supplemental testimony of Peter Czekanski. Mr. Riccitelli provided the calculation of NEGas' earnings under the earning sharing mechanism ("ESM"). He determined that for fiscal year ending June 30, 2003, the return on equity ("ROE") was 15.08 percent, and therefore ratepayers were entitled to a credit of $4,481,783 or $0.0128 per therm for the period November 1, 2003 through October 31, 2004. NEGas determined that its net income available for common equity for fiscal year ending June 30, 2003 was $16,767,045. This was based on various adjustments to NEGas' operating revenues and expenses. First, fiscal year 2003 had a colder than normal winter resulting in $4,302,000 to be returned to ratepayers through the Weather Normalization Clause. As a result, the operating income for purposes of the ESM is reduced by $4,302,000. Second, NEGas' portion of non-firm margins are excluded from fiscal year 2003, or $141,288 from the ESM. Third, NEGas

---

[2] Id. pp. 4-10.
[3] Id. pp. 10-13.

increased operating revenues by $5,227,000 to reverse the effect of the amount recorded for fiscal year 2003 to resolve the ERI II earning sharing calculation. Fourth, NEGas excluded unbilled revenues from the ESM, reducing operating revenues by $746,741 and then reduced operating expenses by $434,938 to reflect unbilled gas costs. Lastly, NEGas included the investors' share of annual net merger savings, or $2,049,000 in operating expenses.[4]

In addition, for the ESM NEGas utilized the statutory rate of 35 percent for calculating NEGas' federal income taxes. Mr. Riccitelli utilized an imputed capital structure of: 43.6 percent common equity, 1.9 percent preferred stock, 45.7 percent long-term debt, and 8.8 percent short-term debt. He also utilized the following cost of capital rates: 11.25 percent for common equity, 9.93 percent for preferred stock, 7.81 percent for long-term debt, and 2.45 percent for short-term debt, which is based on the recent 12 month average cost of short-term debt for Southern Union. Also, NEGas included funds associated with the allowance for funds used during construction in calculating operating income.[5]

In calculating the rate base, NEGas used a five-quarter average ending June 30, 2003. However, Mr. Riccitelli excluded environmental response costs and prepaid taxes from the rate base. He did include construction work in progress in the rate base and computed the working capital allowance pursuant to the method approved in Docket No. 2286. Also, the deferred debits in the rate base included Y2K costs, amortized at the rate of $240,000 per year, and excluded the costs associated with legacy customer-information systems. He noted that earnings between 11.25 percent ROE and 12.25

---

[4] NEGas Ex. 2 (Riccitelli's direct testimony), pp. 2-5.
[5] Id. pp. 5-6.

percent ROE are shared equally between shareholders and ratepayers while earnings above 12.25 percent are shared by giving 75 percent to ratepayers and 25 percent to shareholders. As a result, Mr. Riccitelli calculated $4,481,783 to be returned to ratepayers.[6]

Mr. Czekanski updated the proposed DAC. He updated the LNG commodity costs from $1,643,013 to $1,731,403 or $0.0050 per therm for the System Pressure Factor. Also, he noted that the final fiscal year 2003 costs for the Allens Avenue project reflected an increase of $25,683 and that the environmental expense balances for the Plympton site have been updated from $690,615 to $77,333. However, these changes did not impact the ERC factor. Mr. Czekanski also included the calculation for the ESM of $4,481,783. Accordingly, there is a proposed DAC credit of $0.0118 per therm for a residential heating customer from the former ProvGas service territory and a credit of $0.0650 per therm for a residential heating customer from the former Valley Gas territory. The impact of the proposed DAC on a typical customer bill is a decrease of two percent.[7]

III. DIVISION'S DIRECT TESTIMONY

On October 7, 2003, the Division of Public Utilities and Carriers ("Division") submitted the direct testimonies of Bruce Oliver and David Effron. Mr. Oliver discussed all elements of the DAC except the ESM. For the system pressure factor, Mr. Oliver determined that NEGas' proposed factor filed on September 2, 2003 was mathematically accurate. For the DSM factor, Mr. Oliver noted that $737,503 remains unexpended, and two projects account for $1.2 million or more than 85% of these funds. Accordingly, Mr.

---

[6] Id. pp. 6-8.
[7] NEGas Ex. 3 (Czekanski's supplemental testimony) pp. 2-3.

Oliver found the current DSM funding was more than adequate. For the LIAP factor, Mr. Oliver stated that the LIAP funding is $1,793,901 per year. In fiscal year 2003, $1,511,913 was disbursed for Low Income heating assistance and $200,000 was disbursed for Low Income Weatherization. Mr. Oliver found no reason to question NEGas LIAP funding or its level of funding. Regarding the ERC factor, Mr. Oliver noted that NEGas is seeking approval of a net recovery of ($657,664). This negative amount reflects: a 10-year amortization of $12,510,252 of ERC costs incurred through the end of fiscal 2002; a 10-year amortization of ($5,986,990) of ERC costs for fiscal 2003; and a deduction of $1,310,000 for budgeted base rate recovery of ERC costs. However, Mr. Oliver stated that NEGas has not provided sufficient information to support a determination regarding the reasonableness and prudence of the insurance settlements that NEGas has credited against the costs it has incurred.[8]

In the area of on-system margin credits, Mr. Oliver found that NEGas' calculation was incorrect because NEGas understated the amount non-firm margin revenue for fiscal year 2003. Mr. Oliver stated the correct amount of revenue was $2,192,365 instead of $2,165,151. Thus, the customers should receive $444,274 of this revenue which yields a factor of $0.0013 per therm. As for the weather normalization factor, Mr. Oliver found NEGas' proposed factor to be accurate. Also, Mr. Oliver found NEGas' proposed DAC reconciliation factor to be appropriate.[9]

Mr. Effron's testimony discussed the ESM calculation. Because NEGas had not responded to all the data requests, Mr. Effron made only one initial adjustment. He noted that NEGas concurred that the balance of prepayments included in the rate base was

[8] Div. Ex. 1 (Oliver's direct testimony), pp. 3-12.
[9] Id. pp. 12-18.

overstated. As a result, Mr. Effron reduced the balance of prepayments by $1,227,000 which resulted in NEGas having an ROE of 15.18 percent, resulting in $4,591,000 to be returned to ratepayers.[10]

IV. DIVISION'S SUPPLEMENTAL TESTIMONY

On October 20, 2003, the Division submitted the pre-filed supplemental testimony of David Effron. Mr. Effron updated his ESM calculation. Mr. Effron eliminated the carrying costs on stored gas inventory from revenue and the stored gas inventory from rate base. He noted that the carrying costs on stored gas is handled through the Gas Cost Recovery clause. Also, he stated that this approach is consistent with how the rate base was determined in Docket No. 3401. As a result, NEGas' revenues were reduced by $1,588,000 and its rate base was reduced by $15,296,000.[11]

Mr. Effron recommended the exclusion of $106,337 from NEGas' operation and maintenance expense because the expenditure was described as advertising and public relations. Also, Mr. Effron noted that NEGas accrued $372,000 for incentive compensation to non-executive employees. He stated that this compensation is based on a combination of shareholder goals such as earnings and customer goals such as safety. Mr. Effron compared this compensation program to the executive incentive compensation of Docket No. 2286 in which the Commission disallowed some of the compensation from the cost of service. As a result, Mr. Effron eliminated 50 percent, or $186,000 of the incentive compensation from the cost of expenses. Furthermore, Mr. Effron noted that Southern Union allocated $244,000 to NEGas for the officer and director incentive plan to NEGas, but NEGas did not describe the plan or its goals. Because NEGas did not

---

[10] Div. Ex. 2 (Effron's direct testimony), pp. 1-2.
[11] Div. Ex. 3 (Effron's supplemental testimony), p. 7.

demonstrate that the officer and director plan reflected ratepayer goals, the cost of plan should be eliminated from operating expenses. In addition, Mr. Effron eliminated $69,000 of other interest expenses related to late payments on sales and property tax.[12]

In regards to accumulated deferred income taxes ("ADIT"), NEGas presented a revised calculation in Data Response 4-08 to correct certain errors in the balance of ADIT deducted from rate base. Mr. Effron did not concur with the revision. He stated that NEGas correctly noted that the balance of ADIT of $32,316,489 erroneously included ADIT booked pursuant to SFAS 109. Offsetting this error, Mr. Effron indicated NEGas' failure to record changes to the balance of ADIT since September 30, 2000 when the merger was completed. Mr. Effron did not agree to NEGas' correction of these errors by eliminating the ADIT booked pursuant to SFAS 109 and then increasing the balance of ADIT since September 30, 2000 based on the annual rate of increase used in Docket No. 3401. He stated that NEGas' proposed corrections would increase the rate base by $2,975,000. He emphasized that bonus depreciation, enacted in 2002 for qualifying property acquired after September 10, 2001, was not available to NEGas for the test year of Docket No. 3401. Also, he determined that it is improper for the Southern Union accounting system not to track tax timing differences for ADIT at the NEGas divisional level.[13]

In conclusion, Mr. Effron calculated that NEGas had an ROE of 15.93 percent for fiscal 2003. As a result, the excess revenue to be returned to ratepayers is $5,212,000 or $730,000 greater than NEGas calculated for an ESM factor of ($0.0149) per therm.[14]

---

[12] Id. pp. 2-5.
[13] Id. pp. 5-6.
[14] Id. pp. 6-8.

V. NEGAS' RESPONSIVE TESTIMONY

On October 24, 2003, NEGas submitted responsive testimony by Robert Riccitelli. Mr. Riccitelli agreed with Mr. Effron's reduction of prepayments in rate base as well as the elimination of carrying costs on stored gas inventory from revenue and stored gas inventory from rate base. In regards to the $106,337 expense for advertising and public relations, Mr. Riccitelli acknowledged the reasonable concern of the Division, but maintained the expense involved customer communication efforts related to safety and rate changes rather than image advertising.[15]

In regards to the incentive compensation, Mr. Riccitelli noted that in Docket No. 2286 the Commission disallowed 60 percent of the incentive compensation because two of the four performance objectives benefited shareholders. However, Mr. Riccitelli emphasized that in Docket No. 2286, the Commission was engaged in traditional cost of service rate setting. In contrast, in Docket No. 3401, the Commission approved an ESM whereby increases in earnings provides a benefit to ratepayers. NEGas argued that the incentive compensation plan is designed to encourage employees to seek and institute cost savings. NEGas compared the incentive compensation plan to the costs necessary to achieve merger synergies. Mr. Riccitelli argued that in Docket No. 3401 the costs to achieve these savings were deducted from the total projected savings with the net savings allocated equally between customers and shareholders. In addition, Mr. Riccitelli argued that the rates in Docket No. 3401 included Southern Union's directors' and officers' incentive plan.

As for the exclusion of $69,000 in interest expense, Mr. Riccitelli acknowledged that non-recurring costs are excluded from traditional cost of service rate setting.

[15] NEGas Ex. 4 (Riccitelli's responsive testimony), pp. 2-4.

However, Mr. Riccitelli argued that these costs should be included in the ESM calculation because they were legitimately incurred. Regarding ADIT, NEGas concurred that the balance of ADIT used in the ESM calculation should not include amounts booked pursuant to SFAS 109, and should include changes to the balance of ADIT. However, Mr. Riccitelli noted that this issue is complicated because taxes are calculated and paid at the Southern Union level and there is no current method in place to isolate or approximate changes in the ADIT for Rhode Island operations. As a result, NEGas agreed to no adjustment to ADIT for the ESM calculation until an appropriate methodology is developed. NEGas stated that it will work with the Division to devise this methodology and report to the Commission when it is complete.[16]

Also, Mr. Riccitelli noted that in a data response NEGas stated it was necessary to increase operating expenses by $58,056 in order to match fiscal 2003 revenues with the environmental amortization expenses incurred in fiscal 2003 of $1,251,025. He indicated that the Division did not comment on this correction. Also, Mr. Riccitelli agreed to Mr. Oliver's adjustment to non-firm margins, which decrease the operating margin for purposes of the ESM calculation by $27,214. As a result, NEGas argued that its ROE for fiscal 2003 was 15.48 percent and that $4,671,314 should be returned to ratepayers.[17]

VI. HEARINGS

Following published notice, public hearings were conducted on October 29 through October 30, 2003, at the Commission's offices at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR NEGAS: Craig Eaton, Esq.
Cheryl Kimball, Esq.

---

[16] Id., pp. 8-10.
[17] Id., pp. 10-11.

FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Steven Frias, Esq. Executive Counsel

On October 29, 2003, NEGas presented Mr. Riccitelli as a witness. Under direct examination, he acknowledged an error to expenses, which increased the amount returned to ratepayers by $23,466. Under cross-examination by the Division, Mr. Riccitelli admitted that NEGas has not offered any description of the Southern Union incentive compensation plan. He also agreed it was a risk for NEGas not to pay the taxes while challenging the tax assessment.[18] Under examination by the Commission, Mr. Riccitelli concurred that weather normalization funds are incorporated into the ESM calculation whether it is a warmer than normal or a colder than normal winter. Various questions were asked regarding specific expenses related to advertising, lobbying, private membership dues, legal fees and security services.[19]

Also, Mr. Riccitelli concurred that Section II.M of the Docket No. 3401 settlement stated that NEGas' participation in the ESM was contingent upon the establishment of a service quality plan. He argued that NEGas satisfied this provision when it filed its proposed service quality plan on September 30, 2002.[20] Regarding the establishment of a service quality plan, counsel for NEGas argued that the intent of Section M was to insure that service quality was not harmed in order to achieve earnings.

[18] Tr. 10/29/03, pp. 12, 16.
[19] Id. pp. 20-23, 30-37.
[20] Id. pp. 55-57.

She did admit that the service quality plan was established on June 30, 2003, not when it was filed by NEGas. However, she emphasized that service quality has not degraded.[21]

The Division presented Mr. Oliver as a witness. He recommended the Commission accept NEGas' proposed ERC factor but reserve its right to review the prudence of the expenditures.[22] Under examination by the Commission, Mr. Oliver stated that for the DSM program, if three years pass and there is nothing planned, funds could be returned to ratepayers.[23]

The Division also presented Mr. Effron as a witness. He stated that there is no formula for determining the appropriate amount or percentage of incentive compensation to be disallowed. However, he concurred it is a matter of judgment for the Commission to determine how much of the incentive compensation to exclude from the ESM calculation.[24]

On October 30, 2003, NEGas presented Mr. Czekanski as a witness. Mr. Czekanski stated that NEGas' DSM is actually a load management program which increases the off-peak use of gas thereby reducing the per unit-fixed cost of gas for all ratepayers. Mr. Czekanski acknowledged that NEGas' DSM program is directed towards increased use of fixed cost items during off-peak periods and not conservation.[25]

VII. BRIEFS

On November 14, 2004, NEGas and the Division filed briefs. NEGas argued that Section II.M was intended to ensure that service quality does not decline as a result of NEGas' efforts to maximize merger savings, which results in excess earnings for the

---

[21] Id. pp. 82-85.
[22] Id. pp. 125.
[23] Id. pp. 128.
[24] Id. pp. 176, 183.
[25] Tr. 10/30/03, pp. 6-8, 33.

ESM. NEGas emphasized that fiscal year 2003 was its best year for service quality. NEGas noted that in Narragansett Electric's settlement agreement, Narragansett Electric only loses its share of merger savings if its service quality significantly and persistently deteriorates. In regards to incentive compensation, NEGas maintained that unlike Docket No. 2286, all the goals of the incentive compensation plan benefits ratepayers because higher earnings benefit ratepayers through the ESM.[26]

The Division argued that the Commission should disallow, at a minimum, 50 percent of NEGas' advertising expenses because NEGas could not specifically indicate what amount of the expense was related to safety or customer information. Also, the Division noted that the incentive compensation reduces the refund to ratepayers and NEGas has failed to prove that this incentive benefits ratepayers. Regarding the interest costs, the Division emphasized that these costs could have been avoided if the taxes had been paid pending appeal and is arguably imprudent. Lastly, the Division concurred with NEGas as to its interpretation of the linkage between service quality and the ESM.[27] At an open meeting on October 30, 2003, the Commission adopted the Division's proposed DAC factors on an interim basis.

VIII. <u>RECORD RESPONSES AND DATA RESPONSES</u>

At the hearing, the Commission made numerous record requests. After the hearing, the Commission issued various data requests. In Record Responses 1-03 and 1-05, NEGas acknowledged it had included $67,551 of lobbying/private membership dues in expenses, but NEGas did not contest their exclusion from the ESM calculation.[28] In Commission Data Response 1-02, NEGas indicated that approximately $25,000 of the

[26] NEGas' Brief, pp. 4-8.
[27] Div.'s Brief, pp. 1-3.
[28] NEGas Record Responses 11/13/03.

$372,000 in employee incentive compensation was related to meeting safety and customer-service goals.[29] In Commission Data Response 4-03, NEGas indicated it paid $215,021 in security expenses related to its lock out of Local Union No. 12431 on July 1, 2002 although the expense was billed between May 24 to May 31, 2002. This shifted the expense from fiscal year 2002 to fiscal year 2003. Also, NEGas indicated that it normally paid the security expenses between five to twenty-five days from the date of the invoice was received, but paid the last two invoices on July 1, 2002, thirty-one to thirty-eight days after the invoices were received.[30]

In Commission Data Response 1-01, the Division stated that under accrual accounting security expenses should have been included in fiscal year 2002. In Commission Data Response 1-02, the Division noted that if the security expense was included in fiscal year 2002, it would have had no impact on earnings sharing because of the cap on O&M expenses for ProvGas. However, if the security expenses were included in fiscal year 2003 it would affect earnings sharing.[31] In addition, NEGas incurred $1,403,122 in legal expenses for fiscal year 2003, of which approximately $5,000 related to an appeal of a Commission Order involving the Gas Purchasing Incentive Plan.[32] Also, NEGas indicated that its bad debt write offs were $5,650,615 for fiscal year 2003. Of this total, $1,863,048 was due to 1257 residential accounts with balances of $1,000 or more.[33]

At an open meeting on April 15, 2004, the Commission reviewed the evidence and adopted final DAC factors. The DAC factors included an ESM factor which

[29] NEGas Data Responses 2/13/04.
[30] NEGas' Data Responses 3/16/04.
[31] Div. Data Responses 3/16/04.
[32] NEGas Record Response 1-05 11/13/03 and NEGas Rate Response 1-06 2/13/04.
[33] NEGas Data Response 1-09 2/13/04.

disallowed lobbying and private membership dues, late interest expenses, the Southern Union incentive to officers and directors, $215,021 of security expenses, $173,500 of the incentive to NEGas employees and 50 percent of advertising expenses.

COMMISSION FINDINGS

I. NON-ESM PORTION OF THE DAC

The DAC is composed of various factors: LNG, ERC, DSM, LIAP, Weather Normalization, On-System Margin, Consolidation Mitigation Adjustment, ERI II, Reconciliation, and the ESM. In regards to the LNG factor, LNG commodity costs are projected to increase to a level requiring $0.0050 per therm. The rate increase is therefore needed and justifiable. Also, NEGas reduced the ERC factor to $0.0019 per therm. The environmental response costs incurred through June 30, 2003 and incorporated into the factor have not been reviewed for prudence or reasonableness. As a result, the Commission approves the decrease in the ERC factor as being in the public interest but expressly reserves the right to review the prudence and reasonableness of these costs. In addition, NEGas proposed a Weather Normalization credit of $4,302,000 to reflect the colder than normal winter of 2002 to 2003. This credit was appropriately calculated and the decrease is in the best interest of ratepayers. As for the non-firm margin factor, NEGas filed a credit of $0.0012 per therm or $423,863. However, the Commission finds that the Division's calculation of $444,274 or $0.0013 per therm is accurate. The Commission adopted this decrease because it is in the best interest of ratepayers. Regarding the reconciliation factor, NEGas proposed a factor of $0.0011 per therm due to LNG commodity costs being higher than projected for fiscal year 2003. The undercollection needs to be recovered and therefore the Commission approves this factor.

The remaining components of the DAC, except the ESM factor, were unchanged. However, the Commission could reduce the DSM factor if the funds are not being utilized. Furthermore, the NEGas' DSM is, in reality, a load management program designed to increase load growth during non-peak periods. At a future date, the Commission may investigate the need, the funding, and the structure of this DSM program. As for the LIAP factor, the Commission reiterates that there is already approximately $1.8 million in ratepayer funds being utilized to assist low income families. At a future date, the Commission may review whether the LIAP is an appropriate use of ratepayer funds.

II. ESM

Under Title 39 of the Rhode Island General Laws, the General Assembly has delegated its ratemaking power to establish just and reasonable rates to this Commission. One approach to establish just and reasonable rates is the settlement agreement process outlined in Commission Procedure Rule 1.24. However, since it is the Commission that establishes just and reasonable rates, the Commission has the obligation to interpret a settlement agreement and the order approving it.[34] In this case, the Commission must interpret the NEGas Merger Rate Settlement approved by Order No. 17381 in Docket No. 3401. The most pertinent phrase of the NEGas Merger Rate Settlement in calculating earning sharing is that the financial results "will be adjusted to reflect established Commission ratemaking principles."[35] Unsurprisingly, differences arose during the

[34] Order No. 17524, pp. 70-72.
[35] Order No. 17381, Settlement Agreement, p. 10.

proceedings as to how to calculate NEGas' earnings for fiscal year 2003. The Commission will now review each of the Division's proposed adjustments as well as other adjustments that the Commission, on its own initiative, deemed necessary to consider.

A. UNCONTESTED DIVISION ADJUSTMENTS

The Division made an initial adjustment to NEGas' ESM calculation by reducing NEGas' overstated balance of prepayment included in the rate base by $1,227,000. NEGas concurred with the adjustment. This is consistent with the NEGas Merger Rate Settlement and the Commission's ratemaking principles. Also, this adjustment increases the amount of earnings to be returned to ratepayers. Accordingly, the Commission finds the Division's adjustment to be reasonable.

Also, the Division eliminated carrying costs on the stored gas inventory of $1,558,000 from revenues as well as the stored gas inventory of $15,296,000 from rate base. NEGas did not contest this adjustment. The Division adjustment is appropriate because carrying costs on stored gas are handled through the Gas Cost Recovery Clause. Also, this approach is consistent with how the rate base was determined in Docket No. 3401. Furthermore, this adjustment increases the amount of earnings to be returned to ratepayers. As a result, the Commission finds the Division's adjustment to be reasonable.

The Division also made an adjustment to non-firm margin revenues, which increased the amount of ratepayers' credit to $444,274 from $423,863 and therefore increased NEGas shareholders' portion of non-firm margin revenues to $148,091 from $141,288. Because NEGas' portion of non-firm margins is specifically excluded from the ESM calculation, a revision must be made to bring consistency between the calculation of non-firm margin factors and the calculation of the ESM factor.

In regards to the ADIT, in Division Data Response 4-08 NEGas attempted to present a revised calculation to the balance of ADIT deducted from the rate base. The Division disagreed with the revised calculation because NEGas did not record changes to the balance of ADIT since September 30, 2000, the date of merger, and did not demonstrate the effect of bonus depreciation enacted as a result of September 11, 2001. NEGas acknowledged that there should be a method to approximate changes in the ADIT for Rhode Island. As a result, NEGas agreed to make no adjustment to ADIT and instead will work with the Division to develop a methodology to calculate ADIT. The Commission agrees that a revision to the calculation of the ADIT need not occur at this time. Because NEGas is not a separate corporate entity, it is difficult and complicated to calculate the ADIT for Rhode Island operations. Accordingly, the Commission encourages NEGas and the Division to devise an ADIT methodology for NEGas.[36]

B. ADVERTISING AND PUBLIC RELATIONS EXPENSE

The Division argued for the exclusion of $106,337 in advertising and public relations expense. It is an established Commission ratemaking principle that advertising expenses that are designed to promote the public image of the utility are disallowed. Some of the documentation produced by NEGas clearly falls under this exclusion such as the New Year's greeting by Mr. Robillard. However, advertising expense is allowed if it will promote conservation, safety or is educational in nature.[37] Some documentation was

[36] The Commission also accepted NEGas uncontested adjustments to increase operating expenses by $58,056 in Mr. Riccitelli's responsive testimony and the increase in earning sharing for ratepayers of $23,466 made in Mr. Riccitelli's revised schedules filed on October 29, 2003.
[37] Order No. 14859 and R.I.G.L. 39-2-1.2.

related to conservation, safety and the Commission's Termination Rules. After a review of the documentation, the Commission finds that half of the documentation was designed to promote NEGas' public image. Accordingly, the Commission will disallow $53,169, or half of the advertising expense from the ESM calculation.

C. INTEREST EXPENSE

The Division advocated for the exclusion of $69,000 in interest expense resulting from NEGas' late payments on sales and property taxes. NEGas acknowledges that this expense is non-recurring and would therefore be excluded from a traditional cost of service rate setting. However, NEGas argued that these interest expenses were legitimately incurred and therefore should be included in the ESM calculation. It is an established ratemaking principle that non-recurring costs can be excluded from a traditional cost of service rate case.[38] More importantly, the Commission can disallow imprudent expenses incurred by the utility.[39] In these circumstances, NEGas incurred interest on late payments on sales and property taxes. NEGas could have avoided these interest charges if it had simply paid these taxes pending appeal. This approach would have protected NEGas' legal rights and avoided an unnecessary interest expense. NEGas did not present a reasonable rationale as to why it did not pay its taxes pending appeal so as to avoid these interest charges. Accordingly, the Commission finds that the interest expense on these late payments was imprudent and therefore must be excluded from the ESM calculation.

[38] Leonard Saul Goodman, The Process of Ratemaking, pp. 470-471 (1998).
[39] Id. pp. 855-859.

D. INCENTIVE COMPENSATION

The Division argued for the exclusion of the Southern Union officers' and directors' incentive plan, which totaled $244,000 from the ESM calculation. In addition, the Division advocated for the exclusion of fifty percent of NEGas' non-executive employee incentive compensation. Because the non-executive NEGas employee incentive compensation is $372,000, the Division indicated that $186,000 should be excluded from the ESM calculation. Regarding the Southern Union officers' and directors' incentive plan, the Division noted that NEGas did not describe the plan and did not demonstrate that the plan reflected ratepayers' goals. NEGas countered that the rates arising from Docket No. 3401 included Southern Union officers' and directors' incentive plan. Regarding the incentive compensation plan for NEGas non-executive employees, the Division noted that this incentive plan is based on a combination of shareholders and ratepayers goals, and thus, the Division reasoned that 50 percent of the incentive plan should be excluded from the ESM calculation as was similarly done in Docket No. 2286. NEGas countered that in Docket No. 2286 the Commission was involved in a traditional cost of service rate case while in Docket No. 3401 the Commission approved an ESM that allows increases in earnings to benefit ratepayers as well. Also, NEGas argued that the non-executive incentive plan is designed to institute cost savings, such as merger synergies.

It is an established Commission ratemaking principle that the costs of an incentive compensation plan should not be recovered from ratepayers unless the incentive compensation is designed to benefit ratepayers.[40] In regards to the Southern Union officers' and directors' incentive plan, NEGas failed to describe the plan or indicate how

[40] Order No. 14859.

it benefits ratepayers. NEGas' argument that this incentive plan was incorporated in the rates approved in Docket No. 3401 is also flawed. First, in Docket No. 3401, the Commission approved the NEGas Merger Rate Settlement, which did not specifically indicate that the Southern Union officers' and directors' incentive plan was included in rates. Second, the Division, which was a party to the NEGas Merger Rate Settlement, has objected to inclusion of the plan and in the ESM calculation. Therefore, there was not an agreement among the parties to include this expense in rates. Under these circumstances, the Commission finds that the Southern Union officers' and directors' incentive plan should be excluded from the ESM calculation.

As for NEGas' non-executive incentive compensation, in Docket No. 2286 the Commission disallowed 60 percent of the ProvGas executive incentive plan because it was based on achieving earnings for shareholders rather than safety, customer service, or other ratepayer goals. Strictly following the principle established in Docket No. 2286, the Commission could disallow $347,000 of the $372,000 non-executive compensation because only $25,000 of the compensation was related to safety or customer service.[41] However, the principle established in Docket No. 2286 was based on traditional cost of service ratemaking. NEGas is currently under performance based ratemaking and thus, NEGas' over earnings does benefit ratepayers to some extent through earnings sharing. But, the purpose of performance-based ratemaking for ratepayers is not excess earnings but rate stability by incenting the utility to be efficient. Earnings sharing is a positive by-product for ratepayers but it is not the goal of performance-based ratemaking. As a result, the Commission will not allow all the expense of the non-executive compensation plan to be included in the ESM calculation.

[41] NEGas Data Response 1-2 (1/22/04).

Because ratepayers, under performance based ratemaking with an ESM, do benefit from over earnings, it is reasonable to include some portion of the incentive compensation in the ESM calculation. Because under the ESM ratepayers receive 50 percent to 75 percent of over earnings, and 50 percent of merger savings are shared with ratepayers, it appears fair and reasonable for 50 percent of the incentive compensation related to achieving earnings, or $173,500 to be included in the ESM calculation. However, in the future, the Commission will remain vigilant to insure that an incentive does not become too large, too easy to achieve, or become based on factors that are a detriment to ratepayers.

E. LOBBYING EXPENSES AND PRIVATE MEMBERSHIP DUES

On its own initiative, the Commission reviewed NEGas' lobbying expenses and NEGas' payment of private membership dues. It is a ratemaking principle that lobbying expenses and private membership dues are not legitimate ratepayer expenses.[42] The Commission determined that $67,551 of NEGas fiscal year 2003 expenses were related to lobbying and private membership dues. Accordingly, the Commission finds that these lobbying expenses and private membership dues must be excluded from the ESM calculation.

F. SECURITY EXPENSES

The Commission, sua sponte, reviewed the security expenses NEGas incurred during the lock-out of Local Union No. 12431 in fiscal year 2002. It is an established ratemaking principle that accrual accounting is utilized and that expenses are included in the fiscal year they are accrued rather than the fiscal year the expenses are paid.[43] The

[42] See e.g. Order Nos. 9411, 9069, and 9062.
[43] Div. Data Resp. 1 (3/16/04).

Commission discovered that security expenses related to the lock out were incurred between May 24 and May 31, 2002, but were not paid until July 1, 2002, the beginning of a new fiscal year. The practice of paying expenses accrued in one fiscal year in another fiscal year is not significant for the ESM calculation if in both years, the utility clearly exceeded its authorized ROE. However, in this case Providence Gas had a cap on its O&M expenses in fiscal year 2002, but NEGas had no cap for its O&M expenses in fiscal year 2003.[44] ProvGas exceeded its cap for O&M expenses in fiscal year 2002. As a result, the $215,021 of security expenses incurred in fiscal year 2002 would have no impact on the ERI II earnings calculation, but if they were recorded in fiscal year 2003, the effect would be to reduce earning sharing for ratepayers.[45] It appears NEGas may have been aware of the ramifications of this approach because NEGas routinely paid its security expense between 5 to 25 days from the date of the bill but with the last two invoices NEGas took 31 to 38 days to pay the invoices and paid them on the first day of the new fiscal year.[46] The Commission does not look favorably or kindly upon this accounting sleight of hand. Accordingly, the Commission finds that $215,021 of security expenses must not be included in the ESM calculation.[47]

G. LEGAL EXPENSES

The Commission analyzed NEGas' legal expenses, which totaled $1,403,122 in fiscal year 2003. On its face, this appears to be a rather large amount. It is an established

[44] Compare Order No. 17381, Settlement Agreement with Order No. 16584, Settlement Agreement.
[45] Div. Data Resp. 2 (3/16/04).
[46] NEGas Data Response 4-3.
[47] The Commission could have examined if this security expense should be disallowed on the basis it was a one-time non-recurring expense or because the lock-out expense should be borne by shareholders. However, it is unnecessary for the Commission to engage in either analysis because the Commission has determined that NEGas has not followed accrual accounting.

Commission ratemaking principle to disallow unreasonable legal expenses.[48] After conducting discovery, there is not any specific expense that clearly rises to the level necessary for disallowance. There is a legal expense totaling less than $5,000 that is questionable because it relates to an appeal of a Commission order that NEGas later withdrew. However, the amount in question is not significant and in recent proceedings it appears NEGas is attempting to reduce unnecessary legal expenses. Accordingly, the Commission will not disallow any of NEGas' legal expenses for fiscal year 2003, however, the Commission will continue to monitor the level and nature of NEGas' legal expenses.

H. <u>BAD DEBT WRITE OFFS</u>

The Commission examined NEGas' bad debt write offs, which totaled $5,650,615 for fiscal year 2003. Of this amount, $1,863,048 was due to 1,257 residential accounts with balances of $1,000 or more.[49] It is a ratemaking principle that a utility must conduct its operations in an efficient manner and therefore bad debt write offs arising from poor utility collection efforts can be disallowed.[50] The Commission has indicated that when a customer's balance exceeds $1,000, NEGas should vigorously pursue collection activities.[51] However, NEGas raised legitimate reasons as to NEGas' difficulties in being more pro-active in its collections policy. NEGas noted that R.I.G.L. Section 39-2-23 requires that NEGas employees have two years of experience at a gas utility before being allowed to terminate services. In addition, NEGas described all the numerous and extensive restrictions in the Commission's own Termination Rules that are placed on

[48] Order No. 13877.
[49] NEGas Data Response 1-09.
[50] <u>See</u> Leonard Saul Goodman, <u>The Process of Ratemaking,</u> pp. 273, 314 (1998).
[51] Order No. 17606.

NEGas in its efforts to terminate service for non-payment. At this time, it appears NEGas is making a pro-active effort in its collection efforts. Under the circumstances, the Commission will not disallow any of bad debt write offs from the ESM calculation, however the Commission expects NEGas to use its utmost efforts to keep its uncollectibles low so that bad debt write offs do not reach a high level.

I. SERVICE QUALITY PLAN

Lastly, the Commission interpreted II.M of the NEGas Merger Rate Settlement. The pertinent sentence stated that: "the Company's ability to participate in the ESM will be linked to the establishment of the Service Quality Plan". Since NEGas' SQP was not approved until June 30, 2003 for effect July 1, 2003, the question arises as to whether NEGas can retain any portion of its over earnings for the fiscal year ending June 30, 2003 under the terms of NEGas Merger Rate Settlement.

It is an established Commission ratemaking principle that the Commission has the authority to interpret settlement agreements.[52] A strict interpretation of Section II.M would indicate that NEGas would not participate in the ESM and therefore not receive any share of its over earnings for fiscal year 2003. It is clear that "establishment" requires Commission approval and the Commission did not approve the SQP until the end of fiscal year 2003. Therefore, the condition precedent for NEGas' participation in the ESM was not satisfied. However, the Commission must review the purpose behind the provision. As Justice Cardozo once stated, a judicial body in interpreting a contract provisions "must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence."[53] Furthermore, if "the non-

[52] Order No. 17524.
[53] Jacobs & Young v. Kent 129 N.E. 889 (1921).

occurrence of a condition would cause disproportionate forfeiture," a judicial body "may excuse the non-occurrence of that condition".[54] The purpose of this provision was to insure that service quality was not harmed in order to achieve excess earnings. During fiscal year 2003, NEGas' service quality did not degrade. In fact, fiscal year 2003 proved to be NEGas' best year for service quality in its recorded history and served as the benchmark of the SQP. Also, NEGas' exclusion from the ESM for fiscal year 2003 would cost shareholders over $2 million. Under these circumstances, it is apparent that the purpose of Section II.M was satisfied, NEGas has substantially performed its obligation and the forfeiture is disproportionate. Accordingly, the Commission finds NEGas can participate in the ESM for fiscal year 2003.

CONCLUSION

At its open meeting on October 30, 2003, the Commission adopted an interim ESM factor returning $5,212,000 to ratepayers. With the adjustments approved by the Commission at an open meeting on April 15, 2004 and elaborated in this order, this increases the amount to be returned to ratepayers to approximately $5.4 million. Since the difference between the interim and final rates is rather small, less than $200,000, the difference can be implemented with the new DAC factor that takes effect on November 1, 2004

Although the DAC proceeding resulted in a larger refund to ratepayers than the prior DAC proceeding discussed in Order No. 17524, this proceeding was much less contentious. As to be expected, the sequel was not as dramatic as the original, which in these circumstances was a positive development and reflects the improved regulatory approach NEGas has undertaken.

[54] Restatement of Contracts (2nd), Section 229.

Accordingly, it is

(17971) ORDERED:

1. The system pressure factor of $0.005 per therm filed on September 2, 2003 by New England Gas Company is approved for effect November 1, 2003.
2. The environmental response cost factor of ($0.0019) per therm filed on August 2, 2003 by New England Gas Company is approved for effect November 1, 2003.
3. The weather normalization factor of ($0.0123) per therm filed on August 2, 2003 filed by New England Gas Company is approved for effect November 1, 2003.
4. The reconciliation factor of $0.0011 per therm filed on August 2, 2003 filed by New England Gas Company is approved for effect November 1, 2003.
5. The on-system margin credit factor of ($0.0013) per therm corrected on October 24, 2003 by New England Gas Company is approved for effect November 1, 2003.
6. The Earnings Sharing Mechanism factor ($0.0149) cents per therm proposed on October 20, 2003 by the Division of Public Utilities and Carriers is approved on an interim basis for effect November 1, 2003.
7. The Earnings Sharing Mechanism factor will be adjusted to reflect the adjustments made by the Commission within this Report and Order for effect November 1, 2004.
8. New England Gas Company shall comply with all other findings and instructions contained in this Report and Order.

EFFECTIVE NOVEMBER 1, 2003 AT WARWICK, RHODE ISLAND PURSUANT TO OPEN MEETINGS ON OCTOBER 30, 2003 AND APRIL 15, 2004. WRITTEN ORDER ISSUED AUGUST 23, 2004.

PUBLIC UTILITIES COMMISSION

____
Elia Germani, Chairman

____
Kate F. Racine, Commissioner

____
Robert B. Holbrook, Commissioner